THE "CONTROL" OF TRUST INCOME BY THE GRANTOR AND THE TAX IMPLICATIONS

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I. Introduction

This paper seeks to briefly consider the factors that trigger the taxation of trust income to the grantor in the context of life insurance trusts. In the early U.S. Supreme Court decision, *Burnet v. Wells*, the Court decided that the income of irrevocable trusts which was applied to premium payments for insurance policies on the grantor's life for the purpose of supporting his dependents was taxable to the grantor of the trusts whose beneficiaries were his family members[1].

Considering *Wells* serves as a basic study of such fundamental issues as the attribution of income and the tax unit (person-based, family-based, and so on).[2] These issues have always existed at the root of income tax law. For example, *Wells* might be a clue to the solution of *Helvering v. Horst*,[3] whose subject was the attribution of income among family members.[4] Though it might be said that the grantor trust rules, one of

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1 Burnet v. Wells, 289 U.S. 670 (1933).

2 The attribution of income might be problematic when the owner of the property is not the same as the owner of the income derived from the property. As for the tax unit, when the attribution is made within a group made of intimate persons such as a family, we might think of the group as one tax unit.

3 Helvering v. Horst, 311 U.S. 112 (1940). In *Horst*, the holder of the bonds detached and gave the interest coupons of the bonds to his son before the coupons matured. The question was whether the gift was the realization of income taxable to the donor, not to his son. The Court decided in favor of taxation to the donor, holding that realization might occur when the last step was taken by which he obtained the fruition of the economic gain which had already accrued to him even where the taxpayer did not receive payment of income in money or property. *Horst*, 311 U.S. at 115. Moreover, the Court stated that the exercise of the power to dispose of income, which was the equivalent of ownership of the income, in order to procure the payment of income to another was the enjoyment and hence the realization of the income by him who exercised it. Id. at 118.

4 Actually, in *Horst,* the Supreme Court referred to *Wells* three times. Most importantly, the Court referred to *Wells* in insisting that "[e]ven though he [the donor] never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended

which I will discuss in this paper, are not as impactful as they had been previously,[5] nevertheless an examination of the reasons why the grantor was taxable in *Wells* is still useful in considering issues in the wider context such as the attribution of income generally or the ownership of income.

Compared to the series of famous Supreme Court decisions on grantor trusts,[6] the following two points are characteristic of *Wells*. First, trusts in *Wells* were irrevocable, hence the grantor had permanently parted with the ownership of the trust property. Secondly, the use to be made of the trust income was subject to the will of the grantor announced at the beginning of the trust. Why should the trust income be taxable to the grantor when he has transferred the property from which the income arises to the trust and has no ownership of it thereafter? To explore this question, this paper first examines the holdings of *Wells*, and then, by investigating the subsequent cases, tries to make it clear to what extent the factors *Wells* gave as the grounds for the taxation to the grantor should apply.

II. The Content and History of I.R.C.§ 677(a)(3)

In *Wells*, the Court held that the trust income was taxable to the grantor based on Section 219(h) of the Revenue Acts of 1924 and 1926, which is the predecessor of I.R.C.

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them for any of the purposes named." Id. at 117. In short, though the taxpayer did not receive any money in reality, he could enjoy the same satisfaction as the one he might have enjoyed by the receipt and the expenditure of the money. In *Horst*, the satisfaction of the donor was the same as the one he might have obtained by receiving the interest of the coupons for himself. In *Wells*, the satisfaction of the grantor was the same as the one he might have obtained by receiving the benefits of the insurance (though it could not really occur because the benefits would be paid on his death).

[5] Now both the incentive and the ability of taxpayers to shift income from a person in a higher tax bracket to a person in a lower tax bracket is lower because of the weaker progressivity of income tax rates than before, the compressed tax bracket applicable to trusts, filing the joint return by marital taxpayers, and so-called kiddie tax. See Jay A. Soled, Reforming the Grantor Trust Rules, 76 Notre Dame L. Rev. 375, 376-377 (2001). Moreover, according to Soled, in the present situation, the application of the grantor tax rules by the Service is almost always meaningless. See id. at 397-398.

[6] For the famous decisions on grantor taxation, see e.g., Corliss v. Bowers, 281 U.S. 376 (1930), Helvering v. Clifford, 309 U.S. 331 (1940), and Douglas v. Willcuts, 296 U.S. 1 (1935). For the details of *Corliss* and *Clifford*, see infra notes 36, 37 and their accompanying text. In *Douglas*, the issue was whether the net income of the trust fund received by the wife in lieu of alimony and other support was taxable to the wife or the husband when the husband created the trust upon divorce to pay the money. The Court held that the income was taxable to the husband, for it was paid to the wife under the divorce decree to discharge his obligation, and hence the income stood substantially on the same footing as though he had received the income personally and had been required by the decree to make the payment directly. *Douglas*, 296 U.S. at 9.

§ 677(a)(3). It is said that the provision has been preserved without change since its enactment in 1924, save for the expansion in 1969 to include life insurance for the grantor's spouse.[7] In this Part, the outline of the grantor trust rules and I.R.C. § 677(a)(3) are briefly explained as background for the next Part.

A. The Content

When the grantor of a trust transfers his property to the trust, his ownership of the property is terminated and legally the trustee starts to own it.[8] But in some particular cases, trust income derived from the trust property is statutorily provided to be taxable to the grantor. Such rules aim at paper-thin arrangements designed primarily for tax avoidance, hence these rules disregard the existence of a trust for most purposes by taxing the grantor as though he or she still owns the transferred property.[9]

I.R.C. § 677, whose title is "Income for benefit of grantor," provides at (a)(3) that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under I.R.C. § 674, whose income without the approval or consent of any adverse party[10] is, or, in the discretion of the grantor or a nonadverse party, or both, may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.[11] I.R.C. § 677(a)(3) is said to be a piece of "a progressive endeavor by the Congress and the courts to bring about a correspondence between the legal concept of ownership and the economic realities of enjoyment or fruition."[12]

The point of I.R.C. § 677(a)(3) is that it taxes a grantor on income that is or may be used to pay for insurance on the life of the grantor or the grantor's spouse, even if neither the grantor nor the spouse has any other interest in the trust property and the insurance

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[7] See Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶80.5.

[8] Trusts are independent taxpayers and the rate schedule for trusts are different from that for personal taxpayers. I.R.C. § 1(e).

[9] See Bittker & Lokken, supra note 7, ¶81.1.1. Actual distributions by the trustee to beneficiaries are treated for income tax purposes as gifts to them by the grantor, excludable from the recipient's gross income by virtue of I.R.C. § 102(a). Id.

[10] For the meaning of adverse or nonadverse party, see I.R.C. § 672(a) and (b).

[11] In applying I.R.C. § 677(a)(3), there exists an exception concerning insurance policies irrevocably payable for a purpose specified in I.R.C. § 170(c). See the parenthesis in I.R.C. § 677(a)(3).

[12] *Wells*, 289 U.S. at 677.

policy is irrevocably payable to the beneficiaries.[13]

B. The Legislative History

According to the report of the House Ways and Means Committee, the purpose of the predecessor of I.R.C. § 677(a)(3) was the prevention of tax evasion by distributing the grantor's income while retaining its use.[14] The Court opinion in *Wells* stated: "One can read in the revisions of the Revenue Acts the record of the government's endeavor to keep pace with the fertility of invention whereby taxpayers had contrived to keep the larger benefits of ownership and be relieved of the attendant burdens."[15] But it is not clear from legislative materials why life insurance trusts which pay life insurance premiums are treated differently than trusts whose income is or may be used for other purposes.[16]

III. The Details of *Wells* and Its Reasoning in Favor of Taxation

In *Wells*, the taxpayer, that is, the grantor of the trusts, argued he should not be taxed on the trust income not because the income applied to the payment of the life insurance premiums was not income for the purpose of income taxes,[17] but because imposing taxes on him for the income was wrong and unconstitutional, while admitting that it was truly income. It is important to note that in *Wells,* the Court presented some factors which affected the judgement of whether the grantor had enough ownership of trust income to have taxes imposed on it. The factors leading to the taxation and the ideas on the relationship between the grantor and the trust income shown in the opinion of *Wells* surely have broad implications not only for issues of trusts but also for issues of attribution of income generally. This Part will introduce the facts and circumstances of *Wells*, and then summarize the views of the Court as well as the dissenting opinion in the case.

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13 See Bittker & Lokken, supra note 7, ¶80.5.

14 See H. Rep, No. 179, 68th Congress, 1st Session, p.21. See also S. Rep, No. 398, 68th Congress, 1st Session, pp.25-26.

15 *Wells*, 289 U.S. at 675-676.

16 Bittker & Lokken, supra note 7, ¶80.5 suggests that the rationale of *Wells* does not explain why Congress treated life insurance trusts more severely than trusts whose income is or may be used for other purposes, although the rationale adequately rebuts the taxpayer's constitutional claim.

17 Cf. Eisner v. Macomber, 252 U.S. 189 (1920). In *Macomber*, the taxpayer argued that the stock dividend she received was not income within the meaning of Sixteenth Amendment of the U.S. Constitution. *Macomber,* 252 U.S. at 201.

A. Facts and Circumstances[18]

The facts of the case are as follows. From 1922 to 1923, the taxpayer, Frederick B. Wells, created five irrevocable trusts for the benefit of his relatives, such as his daughter, and transferred certain shares of stock to the trustee. He was not the trustee of the trusts, nor did he have rights to change beneficiaries.

The income of the trusts was to be used to pay the annual premiums for insurance policies on the life of the grantor.[19] After the payment of the premiums, the excess income, if any, was to be accumulated until an amount sufficient to pay an additional annual premium had been reserved. Any additional income was, in the discretion of the trustee, to be paid to the beneficiary. Upon the death of the grantor, the trustee was to collect on the policy, and with the proceeds was to buy securities belonging to the Wells estate. The securities were to be held as part of the trust during the life of the beneficiary, who was to receive the income. On the beneficiary's death the trust was to end, and the corpus was to be divided as she might appoint by her will, and, in default of appointment or issue, to the grantor's sons.

The grantor, in making the returns for his own income for 1924, 1925, and 1926, did not include any part of the income belonging to the trusts. Upon an audit of the returns, the Commissioner of Internal Revenue assessed a deficiency under Section 219(h) of the Revenue Acts of 1924 and 1926 to the extent that the trust income had been applied to premium payments for the life insurance policies.[20]

B. The Opinion of the Court

The main issue of this case was not the meaning of Section 219(h) of the Revenue

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[18] The facts and circumstances of *Wells* are based on *Wells*, 289 U.S. at 672-676.

[19] Two trusts kept alive not only life insurance policies but also several accident policies for the grantor's own use, and the premiums of such accident policies were paid out of the trust income. As to the payment of premiums for accident policies, the Circuit Court of Appeals held that such premiums might be constitutionally taxed to the grantor because the accident policies would give him definite payments in the event of his disability, and hence he was enriched in a definite pecuniary sense to the extent at least of the value of the disability contracts during the tax years that a part of the income was so used. Wells v. C.I.R., 63 F.2d 425, at 442-443 (1933). The payment of the premium for the accident policies were not disputed in the Supreme Court.

[20] There was no attempt to charge him with the excess applied to uses other than the preservation of the policies, and so the deficiency assessment was limited to that part of the income which had kept the policies alive. *Wells*, 289 U.S. at 674.

Acts of 1924 and 1926, nor its applicability to the present case, but "the boundaries of legislative power,"[21] to wit whether or not this provision was against the due process of law under the 5th Amendment of the U.S. Constitution. As to the constitutionality of the statute, the Court cited the legislative history of the provision and the cases concerning the escape of tax burdens by means of income attribution, and then concluded: "Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner, and to tax him on that basis. . . . To overcome this statute the taxpayer must show that in attributing to him the ownership of the income of the trusts, or something fairly to be dealt with as equivalent to ownership, the lawmakers have done a wholly arbitrary thing, have found equivalence where there was none nor anything approaching it, and laid a burden unrelated to privilege or benefit. . . . The statute, as we view it, is not subject to that reproach."[22]

The reasons given in the Court's opinion for deciding that the trust income which was applied to life insurance premium payments should be attributed to the grantor can be divided roughly into two parts: the nature of life insurance contracts generally and the grantor's influence on the trust income.

To begin with, the Court pointed out that by creating trusts, the taxpayer devoted his income for the benefit of relatives and at the same time for the preservation of his own contracts, in other words, for the protection of an interest which he wished to keep alive, and stated that: "The chance that economic changes might force him [the grantor] to that choice [the lapse of contracts because of nonpayment of premiums] was a motive, along with others, for the foundation of the trusts. In effect he said to the trustee that for the rest of his life he would dedicate a part of his income to the preservation of these contracts, so much did they mean for his peace of mind and happiness. Income permanently applied by the act of the taxpayer to the maintenance of contracts of insurance made in his name for the support of his dependents is income used for his benefit in such a sense and to such a degree that there is nothing arbitrary or tyrannical in taxing it as his."[23]

As for the nature of life insurance contracts generally, the Court held as follows: "Insurance for dependents is to-day in the thought of many a pressing social duty. Even

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[21] Id. at 677.

[22] Id. at 678-679.

[23] Id. at 680-681.

if not a duty, it is a common item in the family budget, kept up very often at the cost of painful sacrifice, and abandoned only under dire compulsion. It will be a vain effort at persuasion to argue to the average man that a trust created by a father to pay premiums on life policies for the use of sons and daughters is not a benefit to the one who will have to pay the premiums if the policies are not to lapse. . . . By and large the purpose of trusts for the maintenance of policies is to make provision for dependents, or so at least the lawmakers might not unreasonably assume."[24]

Moreover, in distinguishing from trusts from which the beneficiary can expend the income without restraint, the Court argued that trusts for the preservation of insurance policies involved a continuing exercise by the settlor of a power to direct the application of the income along predetermined channels, to wit: "Here the use to be made of the income of the trust was subject, from first to last, to the will of the grantor announced at the beginning. A particular expense, which for millions of men and women has become a fixed charge, as it doubtless was for Wells, an expense which would have to be continued if he was to preserve a contract right, was to be met in a particular way."[25]

C. The Dissenting Opinion

The dissenting opinion took the transfer of the property by the grantor to the irrevocable trust as important. Stating that "Congress may not tax the property of A as the property of B, or the income of A as the income of B,"[26] the dissenting opinion discussed that "[t]he facts here show that Wells created certain irrevocable trusts. He retained no vestige of title to, interest in, or control over, the property transferred to the trustee. . . . That the property which was the subject of the gift could never thereafter, without a change of title, be taxed to the settlor is, of course, too plain for argument. To establish the contention that the income from such property, the application of which for the benefit of others had been irrevocably fixed, is nevertheless the income of the settlor and may lawfully be taxed as his property, requires something more tangible than a purpose to perform a social duty, or the recognition of a moral claim as distinguished from a legal obligation, which, we think, is not supplied by an assumption of his desire thereby to secure his own peace of mind and happiness or relieve himself from further concern in the matter. . . . In each the motive of the taxpayer is immaterial. The material question is,

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[24] Id. at 681.

[25] Id. at 682.

[26] Id. at 683.

What has he done? not, Why has he done it? . . . Obviously, as it seems to us, the distinction to be observed is between the devotion of income to payments which the settlor is bound to make, and to those which he is free to make or not make, as he may see fit. In the former case the payments have the substantial elements of income to the settlor. In the latter, whatever may be said of the moral influence which induced the settlor to direct the payments, they are income of the trustee for the benefit of others than the settlor."[27]

Furthermore, quite contrary to the opinion of the Court, the dissenting opinion held that "[i]t is not accurate, we think, to say that these trusts involve the continuing exercise by the settlor of a power to direct the application of the income along predetermined channels. The exertion of power on the part of the settlor to direct such application begins and ends with the creation of the irrevocable trusts. Thereafter, the power is to be exercised automatically by the trustee under a grant which neither he nor the settlor can recall or abridge. The income, of course, is taxable, but to the trustee, not to the settlor."[28]

IV. The Three Factors in *Wells*

At that time when *Wells* was decided, the extent of this holding seemed to have been thought of as unclear or limited to the case.[29] But cases after *Wells* have clarified many points in *Wells*. In this Part, in preparation for categorizing these supplementary cases in the next Part, the *Wells* opinion will be divided into three factors: the control of the trust property, the channeling of the trust income, and the enjoyment of the trust income, and each of them will be discussed respectively.

A. The Control of the Trust Property

With regard to life insurance trusts which use the trust income to pay the insurance premiums such as those in *Wells*, the grantor, to wit the transferor of his or her property to the trust, has lost both the ownership and the control of the property transferred.[30]

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[27] Id. at 683-684.

[28] Id. at 684.

[29] See *e.g.* Note, Income Taxes—Who is Subject to Tax—Taxation to Settlor of Income from Irrevocable Trusts Used to Pay Life Insurance Premiums, 47 Harv. L. Rev. 137, 138 (1933) (hereinafter "Note A"); Harry B. Sutter and Anderson A. Owen, Federal Taxation of Settlors of Trusts, 33 Mich. L. Rev. 1169, 1186 (1935); Note, Federal Taxation of Personal Life Insurance Trusts, 44 Yale L. J. 1409, 1413-1414 (1935) (hereinafter "Note B").

[30] See Stanley S. Surrey, Assignments of Income and Related Devices: Choice of the Taxable Person,

Therefore, the reason for the taxation of the trust income to the grantor cannot be that the grantor still has the ownership of the income-producing property transferred to the trust.[31]

In the Court opinion, the reason for the taxation of the grantor for the trust income applied to the life insurance premiums was the continuing exercise by him of a power to direct the application of the income along predetermined channels;[32] in other words, the trust arrangement providing that the trust income should be used for the premium payments of the grantor's life insurance. It was not because the Commissioner thought the grantor owned the trust income or the trust property, nor did he consider the grantor and the trust as one and the same thing.[33]

In *Wells*, the ownership or control by the grantor of the trust property is not the reason for imposing the tax liability for the trust income on him.[34] In that respect, *Wells* is

33 Colum. L. Rev. 791, 823 (1933).

[31] In *Wells*, the Commissioner might not think that the grantor had the ownership or the control of the trust property itself, for the Commissioner assessed the deficiency based on the trust income that was applied to the payment of the life insurance premiums, not on the overall income. For the basis of the assessment of the deficiency, see *Wells*, 289 U.S. at 674.

[32] Id. at 681-682.

[33] It is said that the grantor trust rules recognize the separate existence of a trust when a grantor has parted with dominion and control over the contributed trust property, though they ignore the separate existence when the grantor has retained dominion and control over trust assets. See Soled, supra note 5, at 379.

[34] When the policy proceeds are to go to named beneficiaries and the grantor-insured may not change the designation of the beneficiaries, revoke the trust, or in any manner exercise control over the trust or the policies, the analogy to an outright gift is compelling. See Surrey, supra note 30, at 824. But in *Wells*, it was declared that the statute imposing tax on the grantor in such a situation was constitutional. Id. In the usual situation of an outright gift, the donee, not the donor, of the property has the tax liability for the income from the property.

distinguished[35] from the two famous decisions, Corliss v. Bowers[36] and Helvering v. Clifford.[37]

In *Corliss*, the question was whether the trust income could be constitutionally taxable to the grantor under Section 219(g) of the Revenue Act of 1924 when he reserved the broad power at any moment to abolish or change the trust at his will. Section 219(g) of the Revenue Act of 1924 provided that where the grantor of a trust had the power to revest in himself title to any part of the corpus of the trust at any time during the taxable year, the income of such part of the trust for such taxable year should be included in computing the net income of the grantor. The Court sustained the constitutionality of the provision, holding that "[t]he income that is subject to a man's unfettered command and that he is free to enjoy at his own opinion may be taxed to him as his income, whether he sees fit to enjoy it or not."[38]

In *Clifford,* the dispute was whether the grantor of a trust was taxable to the trust

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[35] Cf. Du Pont v C.I.R., 289 U.S. 685 (1933). In *Du Pont,* which was decided on the same day and had almost the same facts and circumstances as *Wells*, save the term of the trust was limited, like *Wells*, the issue was whether Section 219(h) of the Revenue Acts of 1924 and 1926 was constitutional in its application to trusts for the payment of insurance policy premiums. It was held that the amount of the trust income that was expended by the trustee in the preservation of the policies was taxable to the grantor because he did not divest himself of title in any permanent or definitive way nor did he strip himself of every interest in the subject-matter of the trust estate. In contrast with *Wells* where four judges dissented, *Du Pont* was decided unanimously.

The Court pointed out two reasons why the grantor was taxed on the trust income that was applied to the life insurance premiums. First, the Court declared that this case was ruled by *Wells* and said: "If the income of such a trust may be taxed to the grantor, though he has retained to himself no reversionary interest in the principal of the trust [*Wells*], a fortiori that result must follow where he has made a grant of the estate for a short term of years, reserving the reversion when the term is at an end." *Du Pont*, 289 U.S. at 688.

Second, no matter what the outcome of *Wells* might be, because of the provisions of the trust deeds, the Court held: "[t]he grantor did not divest himself of title in any permanent or definitive way, did not strip himself of every interest in the subject-matter of the trust estate. During a term of three years, the trustee was to apply the income to the preservation of the policies, and while thus applying the income was to hold the principal intact for return to the grantor unless instructed to retain it longer. . . . One who retains for himself so many of the attributes of ownership is not the victim of despotic power when for the purpose of taxation he is treated as owner altogether." *Du Pont*, 289 U.S. at 688-689. It is clearly noted that the four dissenters in *Wells* concurred in *Du Pont* for the second reason. *Du Pont*, 289 U.S. at 689.

[36] Corliss v. Bowers, 281 U.S. 376 (1930).

[37] Helvering v. Clifford, 309 U.S. 331 (1940).

[38] *Corliss*, 281 U.S. at 378.

income when the grantor created a 5-year-trust for the benefit of his wife and declared himself trustee and the remainderman on termination of the trust, retaining the broad power concerning the trust property and the income therefrom. The Court held that the grantor continued to be the owner of the corpus even after the trust was created for purposes of the Section 22(a) of the Revenue Act of 1934 and hence he was taxable for the income from the corpus, holding that "[i]n substance his control over the corpus was in all essential respects the same after the trust was created, as before,"[39] and what the grantor did was "at best a temporary reallocation of income within an intimate family group."[40]

In short, in *Corliss*, the actual command over the property taxed was held to be the actual benefit for which the tax was paid.[41] In *Clifford*, it was clearly stated that the terms of the trust did little to dilute the grantor's dominion and control over the trust property.[42]

On the other hand, the dissenting opinion of *Wells* insisted that the attribution of the trust income should be decided based on the ownership or control to the trust property.[43] As stated below,[44] the Court's opinion in *Wells* allowed the taxation of the grantor because of his channeling of the trust income, advancing the discussion further from the control of the trust income itself, whereas the dissenting opinion held that because the grantor, by creating the irrevocable trusts, "retained no vestige of title to, interest in, or control over, the property transferred to the trustee,"[45] the result was a present, executed, outright gift, and hence "[t]hat the property which was the subject of the gift could never thereafter, without a change of title, be taxed to the settlor is, of course, too plain for

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39 *Clifford*, 309 U.S. at 335.

40 Id.

41 *Corliss*, 281 U.S. at 378; See also Soled, supra note 5, at 382.

42 *Clifford*, 309 U.S. at 335-336; See also Soled, supra note 5, at 384.

43 That the dissenting opinion's criterion of taxation to the grantor was his ownership or control of the trust property itself would be revealed more clearly by comparing to the holding of *Du Pont*. For the details of *Du Pont,* see supra note 35. In *Du Pont*, the four *Wells* dissenters joined the Court's opinion, for the grantor did not divest himself of title in any permanent or definitive way nor did he strip himself of every interest in the subject-matter of the trust estate because of the short term duration of the trust, and hence he retained for himself so many of the attributes of ownership. *Du Pont*, 289 U.S. at 688-689.

44 See infra IV.B of this paper.

45 *Wells*, 289 U.S. at 683.

argument."[46]

B. The Channeling of the Trust Income

The Court's opinion in *Wells* pointed out, as one of the reasons for making the grantor taxable for the trust income which was applied to the grantor's life insurance premiums, that there existed a continuing exercise by the grantor of a power to direct the application of the income along predetermined channels.[47] In other words, it pointed out that the use to be made of the trust income was subject, from first to last, to the will of the grantor announced at the beginning.[48]

It is said that in view of the fact that I.R.C. § 677 was designed to close the gaps created by a variety of devices in which the benefits of ownership of trust income were retained without the attendant tax burdens, the possibility of actual use of trust income, current or accumulated, for the grantor of a trust directly may reasonably be the basis of taxation to the grantor since the terms of the trust disposition may be said to have tax significance.[49] Under I.R.C. § 677(a)(3), the possibility of use refers to possible use pursuant to the trust instrument and not to a mere possibility of use by one who receives the income without restriction of any kind.[50] In the *Wells* opinion, the question of whether Congress could likewise tax the grantor for income which may be expended by the beneficiaries without restraint was expressly reserved.[51] When premiums for the grantor's life insurance are paid with the trust income by the beneficiary of both the trust and the policy, such sums may not be included in the grantor's income if the terms of the trust do not require any part of the income to be applied to the policies owned by the beneficiary.[52] This is because the income is the beneficiary's property, and voluntary

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[46] Id.

[47] *Wells*. 289 U.S. at 681-682.

[48] Id. at 682. In contrast, the dissenting opinion argued that the exertion of power on the part of the settlor to direct such application began and ended with the creation of the irrevocable trusts and thereafter, the power was to be exercised automatically by the trustee. Id. at 684.

[49] See Abraham S. Guterman, The Federal Income Tax and Trusts for Support—The Stuart Case and Its Aftermath, 57 Harv. L. Rev. 479, 498 (1944). This article discusses Section 167 of the Revenue Acts of 1924 and 1926. As to the legislative history of the provision, *Wells* is cited at note 73.

[50] Id. at 485.

[51] See Note, Irrevocable Trusts and the Federal Income Tax, 49 Yale L. J. 1305, 1308 (1940).

[52] Id.

expenditures are not within the statute.[53]

However, whether such application of trust income to life insurance premiums is required in the trust agreement or the beneficiary pays them according to the grantor's instructions made in secret, the grantor receives identical benefits from the income used to discharge his obligations to pay premiums.[54] Therefore, given these outcomes, it is probable that a grantor would seek to avoid taxation by coming to an agreement with his beneficiaries instead of formalizing the arrangement in a trust agreement.[55] It should be researched whether the way the grantor exercises a power to direct the application of the income affects the tax results, or whether the grantor should be taxable to the trust income even if he does not exercise such a power.[56]

C. The Enjoyment of the Trust Income

In *Wells*, by creating trusts, the grantor attained "the preservation of his own contracts, to the protection of an interest which he wished to keep alive,"[57] which is "more than devote his income to the benefit of relatives."[58] The preservation of his life insurance contracts was for "his [the grantor's] peace of mind and happiness,"[59] and it was held that "[i]ncome permanently applied by the act of the taxpayer [the grantor] to the maintenance of contracts of insurance made in his name for the support of his dependents is income used for his benefit in such a sense and to such a degree that there is nothing

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53 Id.

54 Id. at 1309.

55 Id. at 1308-1309.

56 *Helvering v. Horst* is a famous case that deals with the attribution of income from the underlying property among family members, though trusts are not used. For the details of *Horst,* see supra note 3. The important differences of the facts between *Horst* and *Wells* is whether at the time of the transfer the donor imposed any restrictions upon the ultimate use of the income (there was no restriction in *Horst* whereas the use was limited to the payments of life insurance premiums in *Wells*), and whether there was evidence that the income was spent for the benefit of the donor (there was no evidence in *Horst*, whereas the taxpayer in *Wells* admitted that the trust income was applied to the payment of life insurance premiums on life of the grantor). See Note, *Income Tax*es—Who Is Subject to Tax—Donor of Unmatured Bond Coupons Who Retained Scalped Bonds Held Not Taxable on Interest Later Collected by Donee, 53 Harv. L. Rev. 684, 685 (1940).

57 *Wells*, 289 U.S. at 680.

58 Id.

59 Id.

arbitrary or tyrannical in taxing it as his."[60] The opinion explains that insurance contracts for the support of dependents are "to-day in the thought of many a pressing social duty"[61] or "[e]ven if not a duty, it is a common item in the family budget, kept up very often at the cost of painful sacrifice, and abandoned only under dire compulsion."[62]

As to the holding cited above, the following two points have been at issue. First, the life insurance contracts were established for the purpose of supporting dependents after his death, based on moral or social duty,[63] not on a legal one.[64] Therefore, *Douglas v. Willcuts*,[65] which held that the trust income used to discharge the legal duty of the grantor was taxable to him, might not govern *Wells*.[66] It might be true that the grantor has no legal duty to pay the insurance premiums.[67] However, trust income applied to life insurance premiums is, as it is applied to other items of a family budget, used for the benefit of the grantor, in the sense that he can achieve the fulfillment or the discharge of a moral obligation which would otherwise be cared for out of his own funds.[68] Then it

[60] Id. at 680-681.

[61] Id. at 681.

[62] Id.

[63] In Sutter and Owen, supra note 29, at 1185, to support one's own family is expressed as a "natural obligation."

[64] However, it is argued that drawing a line between a strictly legal and a social obligation may be a difficult task. See Guterman, supra note 49, at 490 (fn. 38).

[65] Douglas v. Willcuts, 296 U.S. 1 (1935). For the detail of *Douglas*, see supra note 6.

[66] "Where the obligation has been legal, the tax on the settlor has been upheld, but where the obligation has been only moral, or possibly quasi-legal, the settlor has most often escaped the tax." See Note B, supra note 29, at 1415-1416 (footnotes omitted).

[67] It is because the grantor, namely the insured, can default. See Surrey, supra note 30, at 824. But if one could think of the creation of irrevocable funded trusts as indicative of an intent to retain the policies and have the premiums paid, and actually he has dedicated a part of his income to this end, it might be possible to think that in this sense there is an obligation of the grantor, which he has satisfied by providing a fund the income of which is sufficient to pay premiums of the life insurance. Id.

[68] See Note A, supra note 29, at 137-138. See also Note, Gratuitous disposition of Property as Realization of Income, 62 Harv. L. Rev. 1181, 1184-1185 (1949). (This article discusses *Wells* as an example that made a transfer ineffective when the assignor received some material benefit from its receipt by the assignee, and concludes that control of the income-producing property at the time the income is earned or certainty that the income will be used for material benefits to the donor should determine the incidence of the tax, rather than control at the time the income is received.) For the article supposing that the opinion of *Wells* relied upon the idea that the grantor, under the circumstances, must have been deemed to be receiving the income, at least constructively, because prevention of evasion had been said to be invalid as a primary cause, see Note B, supra note 29, at 1414. Further, "[i]f the [proceeds of the life insurance] policies are payable to the decedent's estate, or a right to

might be problematic whether the trust income used to pay life insurance premiums for someone other than the grantor should be taxable to the grantor if the payment achieves the goal of supporting the grantor's dependents and therefore serves for the grantor's benefit.

Second, the characteristic of *Wells* is that the notion of income which seems to be likened to satisfaction, as economists say, is stressed.[69] Surrey explains that "[t]he enjoyment and benefit derived by a person from the payments to an intended beneficiary is taxable income to the former. The money value of that benefit is measured, quite reasonably, by the amounts so paid to the beneficiary."[70] Applied to *Wells*, it would be that the enjoyment and benefit the grantor obtains by using the trust income to pay the life insurance premiums, measured by the amount of the premiums, is taxable to him if he transfers the life insurance policies for the benefit of his family to the trust, and designates the trustee of the trust as the beneficiary of the policies and appoints the trustee to manage the proceeds of the policies. Since most life insurance trusts are created within a family,[71] this logic raises the issue whether the groups composed of close persons, such as families or some kinds of communities, should be considered to form one tax unit.[72]

V. Implications from Cases After *Wells*

In Part IV above, *Wells* was examined from three perspectives: the control of the trust property, the channeling of the trust income, and the enjoyment of the trust income. As a result, it was made clear that the grantor was held taxable not because he had the ownership of the trust property but because he had the power to use the trust income as he saw fit by arranging the trust instrument to apply the trust income to the payment of life insurance premiums on the life of the grantor. It was also pointed out that the grantor

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change the beneficiary is retained, the grantor is directly obtaining the benefit of premium payments in that they purchase money which may be utilized to pay his debts or for other similar purposes." See Surrey, supra note 30, at 823. On the other hand, in *Wells*, the payment of premiums on accident policies was held to be taxed to the grantor. See supra note 19.

[69] See Note, Developments in the Law, 47 Harv. L. Rev. 1209, 1278 (1934).

[70] See Surrey, supra note 30, at 828.

[71] Id. at 831.

[72] For the articles that imply this issue, see e.g., Surrey, supra note 30, at 831 and Note A, supra note 29, at 138. See also Note, supra note 51, at 1308. ("The Supreme Court's recognition of the family unit as a basis by which benefits to the grantor are measured foreshadows a broad extension of the present concept of taxable income.")

acquired something like a discharge of his obligation or psychological satisfaction from the payment of the life insurance premiums using the trust income.

On the other hand, in view of the nature of life insurance trusts that such transactions are mainly utilized within family units,[73] it is unclear from *Wells* whether the tax results would change depending on whether the person who decides to pay the life insurance premiums is the grantor or another person, especially when family is deemed to be one unit.

This Part will examine the four cases decided after *Wells* that deal with the issue of whether the trust income used to pay life insurance premiums on the life of the grantor is taxable to the grantor when the beneficiary of the trust pays the premiums with the trust income distributed to him or her.

A. Dunning v. C.I.R., 36 B.T.A. 1222 (1937)

In *Dunning*, the taxpayer executed deeds of trust for the benefit of his wife and children and he was one of the trustees. He transferred certain shares of stock of the corporation of which he was president and general manager and owned 95 percent of the stock. The trusts were to continue for about four and a half years, and without written notice by the grantor to his co-trustee that he desired no extension, the trusts were to be automatically extended for five years and for successive periods of five years. In the event of termination of any trust, the corpus of the trust should revert to him.

The taxpayer assigned life insurance policies to his wife, all of which he had been issued prior to the creation of the trusts, with no power reserved with him to change beneficiaries.[74] At the taxpayer's suggestion, she paid all the premiums due in 1933 on the life insurance policies using the trust income distributed to her. She did not enter into any formal agreement with her husband to pay the premiums. Nor could she have paid the premiums out of any of her separate income, excepting the income from the trusts.

The taxpayer argued that the facts did not take this proceeding outside the rule set forth in *Wells*, for the trust instruments did not require any of the income of the trusts be applied to pay life insurance premiums, and to tax him on this part of the income

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[73] See Surrey, supra note 30, at 831. See also note 71 and accompanying text.

[74] As to the life insurance policies assigned by the taxpayer, the wife created the trust and transferred them there. *Dunning*, 36 B.T.A. at 1225. The trustee of the trust was to collect the proceeds of the policies when they become payable and invest the proceeds in securities to be held in the trust estate and distribute the income of this trust to her and her children. Id.

amounted to measuring the income tax of one taxpayer by the income of another. He further contended that if such construction of Section 167(a)(3) was required under the statute, the provision of the statute so construed was unconstitutional.

The Board of Tax Appeals held that the taxpayer "[m]ade the suggestion and there is this evidence of an element of control exercised, it is true, outside of any requirement in the trust agreement,"[75] though the use or purpose of the trust income was not provided for under the trust agreement and hence there was no legal obligation on the wife to use part of the income distributed to her for premium payments. Moreover, the Board of Tax Appeals pointed out that the intent of Congress in enacting Section 219(h) of the Revenue Act of 1926 was to prevent tax avoidance and this statute made no restriction that the income had to be applied to insurance policy premium payments pursuant to the requirements of a trust deed. Consequently, it concluded that the taxpayer was taxable on the amount paid in the taxable year on the life insurance premiums, under the provisions of Section 167(a)(3). Admitting that the opinion in *Wells* left undetermined the validity of such construction, it nevertheless held that the conclusion stated above was correct because the wife had never paid premiums on the policies until the trusts were created, she did so at the suggestion of the grantor, and outside of the terms of the trust, the grantor did exercise an element of control over part of the income paid to the wife and the use of the income so as to prevent a forfeiture of the insurance contracts by failure to pay premiums was a benefit to him.

B. Hexter v. C.I.R., 47 B.T.A. 483 (1942)

In *Hexter*, the taxpayer created a trust for the benefit of his wife. During the taxable years at issue, the grantor and his wife were the co-trustees of the trust and had equal powers concerning trust affairs. The trust instrument provided that all net income of the trust estate should be paid to her and upon her sole request and demand that the income was insufficient to provide for her needs and requirements, such sums as she deemed necessary or desirable were to be paid to her from the principal of the trust. One reason the taxpayer created the trust was to insure financial independence for his wife by getting money out of his hands and, among other reasons, to reward her for her considerate and thoughtful nursing when he had been ill.

About three years before the trust was formed, the taxpayer had transferred life insurance policies on his life over to his wife that he had already owned by himself for

[75] Id. at 1230.

some time at the time of the transfer. The wife had paid the life insurance premiums both before and after the creation of the trust from the checking account she used to deposit the trust income and her other income. The taxpayer, namely the grantor, never exercised any control over the policies after the transfers or intended that his wife should use the trust income for insurance premiums. Nor did the taxpayer and his wife have any agreement that the income of the trust was to be used for paying the insurance premiums.

The Commissioner urged that the income could be and was used to discharge the grantor's obligations and to pay life insurance policy premiums and hence the grantor was subject to tax on the income under Section 167(a)(3) of Revenue Act of 1936.[76] The taxpayer argued that he should not be taxed on the trust income because of the absence of a requirement in the trust instrument requiring application of such trust income either to the payment of insurance premiums or to discharge his obligations. He also contended that the life insurance policies belonged wholly to his wife, and she paid the premiums from a bank account containing other moneys sufficient for that purpose, as well as the trust income, after the trust was set up.

Based on the precedent cases, the Board of Tax Appeals held that Section 167(a)(3) did not apply here, where there appeared in the trust instrument no requirement that the trust income be expended to pay premiums, and where the petitioner had, about three years before the trust was formed, transferred the policies over to his wife. As to *Wells*, the Board held that the Commissioner had erred in invoking the case as indicating that the petitioner had a continuing interest in the policies. The Board also distinguished the case now at issue from *Wells* by the fact that *Wells* did not involve policies assigned by the assured prior to the trust, and did involve a trust instrument making specific provision for use of trust income upon premiums.

C. Booth v. C.I.R., 3 T.C. 605 (1944)

In *Booth,* the taxpayer created trusts for the benefit of his children and transferred

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[76] It is worth noting that in this case the Commissioner suggested that there was a reallocation of family income and that *Clifford* required taxation thereof to the grantor. *Hexter*, 47 B.T.A. at 489. The Board of Tax Appeals, though admitting the existence of the family group, held that there was no right of revocation, no discretion vested alone in the grantor as to use of the trust fund or income, no possible reversion to him, and hence he could benefit in no manner, presently or prospectively, by the trust, but parted permanently from all economic benefit from the corpus and income thereof. Id. at 491. Moreover, it held that with all ownership and co-equal trustee powers in the wife, the fact of family relationship should not be given the effect desired by the grantor, and therefore *Clifford* did not reach so far. Id.

life insurance policies to the trustees. The grantor himself was not the trustee. In creating the trusts, the taxpayer provided that the trustees were not to pay the premiums on the life insurance policies from any funds the grantor transferred to the trust and should be under no obligation to see that said premiums were paid. The trustees were to hold the policies until the death of the grantor, then collect the proceeds and invest them, the income from which was to be distributed to the beneficiaries.

The background of the creation of the trusts was as follows. When the taxpayer felt he was overinsured with life insurance policies and thought to drop some of them and consulted on this matter with his confidential secretary, the secretary suggested an arrangement whereby some policies might be put in trust and his wife could pay the premiums on them out of the income she received from another trust which the grantor created for her benefit. She liked this suggestion and told him that she would pay the premiums, and the taxpayer agreed. She actually paid the premiums using the trust income distributed by the trust her husband created for her benefit.

Though the payment of the premiums by the wife met with the taxpayer's approval, the Tax Court held that this case was distinguishable from *Dunning* in which the factor of control was found to exist by reason of the acquiescence of the wife to her husband's suggestion. The Court distinguished this case because it was clear from the evidence that the taxpayer would have been equally satisfied with the opposite course, that is, the surrender of the policies. Furthermore, the Tax Court pointed out that, in none of the precedent cases, has the voluntary and undirected conduct of the wife resulted in attributing trust income to the grantor husband, particularly where the income was as clearly the unqualified property of the wife as it was here. In conclusion, the Tax Court agreed with the taxpayer's argument.

D. Conant v. C.I.R., 7 T.C. 453 (1946)

In *Conant*, the taxpayer created trusts for the benefit of his wife and children, and transferred interests of his life insurance policy and certain shares of stock to them. The wife was invested with the power and authority to cancel or revoke the trusts at any time, in whole or in part, and moreover, with the further and additional power to alter or amend the trusts in such manner and at such time or times as she might see fit. In the event of cancellation or revocation by her, the whole of the principal of the trust fund, or such part or portion thereof as she might designate, together with any accrued and undistributed income, less the charges thereagainst, were to be paid to her free and discharged of all trusts. The taxpayer, namely the grantor, did not reserve to himself any right, title or interest whatsoever in the property conveyed, but expressly divested himself of all thereof, nor did he reserve any rights whatsoever with respect to amending, varying, controlling, or revoking the trusts.

The wife directed the trustees to apply the trust income to the payment of life insurance premiums, and the trustees paid the premiums in accordance with her request. The Commissioner, basically based on Section 167(a) of the Code, added the amount of the life insurance premiums that were paid with the trust income to the taxpayer's, namely the grantor's, income. The taxpayer contended that it was not he but his wife that was taxable on any of the income of the trusts, because of her unqualified power and authority to cancel or revoke the trusts at any time, in whole or in part, and because, in the event of such cancellation or revocation, the whole of the principal together with any accrued and undistributed income was to be paid to her.

The Tax Court first discussed the precedent cases that held the beneficiary was the owner of the trust income for tax purposes and hence he was taxable on the income under Section 22(a) of the Revenue Acts of 1936 and 1938, because of the powers over trust corpus and income granted to him, namely his unfettered dominion and control over the trust property given by the unqualified power of revocation. Then the Tax Court held that the same reasons as stated above compelled them in this case to the conclusion that the income in question was not the income of the trusts but was the income of the grantor's wife for the tax purpose, and consequently, the premium payments for insurance policies on the petitioner's life made from this income at her direction must have been considered as if made by her from her own income and taxable to her under the provisions of Section 22(a) rather than to the grantor under Section 167(a)(3).[77]

VI. Conclusion

In *Wells*, it was held that the trust income which was used to pay life insurance premiums on the life of the grantor was taxable to him when he created irrevocable trusts for the benefit of his relatives whose income was to be used to pay the premiums under the terms of the trusts. The three features of *Wells* were: (1) the grantor's non-ownership

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[77] "Section 167 by its terms applies only to the income of a trust, i.e., the income from property held in trust which would be taxable to the fiduciary under section 161, were it not for the provisions of section 167. It does not apply to income which is nominally the income of a trust but which is in reality, and for tax purposes, the income owned by a beneficiary having such powers, dominion, and control over the trust corpus as justify her taxation upon such income under the provisions of section 22(a) [I.R.C. § 61(a) of the current law]." *Conant*, 7 T.C. at 462.

of the trust property, (2) the grantor's power to direct the application of the income along predetermined channels, and (3) the grantor's enjoyment of benefits derived from the income. To consider the effect of the second and third factors described above, this paper examined the four cases after *Wells* in which the payment of the life insurance premiums on the life of the grantor was carried out or decided not by the grantor but by the beneficiaries, therefore, which have less or no vestige of the second feature but fully have the third feature. As a result, it became clear that the direction by the grantor to pay the premium with the trust income is equal to the control of the income by him, even though the application of income to the premium is not clearly provided in the trust instrument. The agreement by the grantor on the payment is not enough. Moreover, the grantor is not taxable when the beneficiaries, having ownership of the trust income (or in some cases also the trust property), voluntarily pay the premiums.

Based on the examination above, it became clear that the grantor's power to direct the application of the income along predetermined channels is necessary to impose tax on the trust income to the grantor. On the other hand, the enjoyment by the grantor of benefits derived from the income alone is not sufficient to cause him to be taxed on the income. As to the family tax unit that might be said to be implied in *Wells*, the subsequent cases suggested that even if there exists the creation of trusts or the attribution of income among family members, such close relationship is not enough to cause the grantor to be taxed on the trust income used by the beneficiary.

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